No. 10245

In the United States Circuit Court of Appeals for the Ninth Circuit

CHARLES CHAPLIN, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

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v.

CHARLES CHAPLIN, RESPONDENT

ON PETITIONS FOR REVIEW OF THE DECISION OF THE UNITED STATES BOARD OF TAX APPEALS

BRIEF FOR THE COMMISSIONER

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CITATIONS

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OPINION BELOW

The opinion of the Board of Tax Appeals (R. 20–45) is reported in 46 B. T. A. 385.

JURISDICTION

This case involves the income tax liability of Charles Chaplin for the calendar year 1935. Notice of deficiency was mailed on March 2, 1939 (R. 5, 16), and the petition for redetermination was filed with the Board of Tax Appeals on May 26, 1939 (R. 1), pur-

suant to Section 272 (a) of the Internal Revenue Code. The decision of the Board of Tax Appeals was entered on April 6, 1942. (R. 46.) The taxpayer filed a petition for review on June 8, 1942 (R. 47–54) and the Commissioner filed a petition for review on July 1, 1942 (R. 56–62). By an order of this Court entered on August 1, 1942, the cases have been consolidated for briefing, hearing, argument and decision upon a single consolidated transcript of record. (R. 334–335.) The jurisdiction of this Court rests upon Sections 1141–1142 of the Internal Revenue Code. As of October 22, 1942, by Section 504 of the Revenue Act of 1942, the name of the United States Board of Tax Appeals was changed to The Tax Court of the United States. Although the decision of the Board and the petitions for review were filed prior to that date, since the record was prepared subsequent thereto by the clerk of that tribunal he captioned the record "Upon Petitions to Review a Decision of the Tax Court of the United States."

QUESTIONS PRESENTED

In 1935 the taxpayer received certain shares of stock together with "accrued dividends" thereon from a depositary who held the stock in escrow under an agreement pursuant to which the stock was to be delivered to the taxpayer only upon the performance by him of certain conditions.

1. Does the record compel a conclusion that the Board erred in holding that the stock and "accrued dividends" were taxable as income to the taxpayer in 1935?

2. Was the item designated "accrued dividends" a dividend within the meaning of Section 25 (a) (1) of the Revenue Act of 1934 so as to be free from normal tax?

STATUTES INVOLVED

Revenue Act of 1934, c. 277, 48 Stat. 680:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever.

SEC. 25. CREDITS OF INDIVIDUAL AGAINST NET INCOME.

(a) *Credits for Normal Tax Only.*—There shall be allowed for the purpose of the normal tax, but not for the surtax, the following credits against the net income:

(1) *Dividends.*—The amount received as dividends from a domestic corporation which is subject to taxation under this title.

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this title (except in section 203 (a) (4) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, out of

its earnings or profits accumulated after February 28, 1913.

STATEMENT

The facts, as found by the Board of Tax Appeals, may be summarized as follows:

On February 5, 1919, the taxpayer, and Douglas Fairbanks, Mary Pickford and David W. Griffith entered into an agreement to associate themselves in the distribution of motion pictures thereafter produced by them. All of the parties were favorably known in all parts of the world where motion pictures were exhibited and their respective names had exceptional trade value. The agreement provided, *inter alia,* that they would organize a corporation to be known as the United Artists Corporation. The capitalization of the corporation was to consist of 6,000 shares of eight percent, $100 par value, cumulative, preferred stock and 9,000 shares of no par common stock. Each of the parties was to purchase 1,000 shares of the preferred stock at $100 per share, but it was contemplated that this stock would be redeemed by the corporation. (R. 23.) The common stock was to be issued and paid for in the following manner (R. 23–24):

> One thousand (1,000) shares to each of the above named persons in part consideration of the execution and fulfillment of the contract pertaining to the exploiting, marketing, distributing and turning to account of his or her motion pictures with the said corporation. The details concerning the delivery of the aforesaid common shares of stock to each of the aforesaid

persons shall be more fully set forth in the agreement between said person and said corporation pertaining to the exploiting, marketing, distributing and turning to account the motion pictures produced by such person and included in such contract.

One thousand (1,000) shares to William G. McAdoo who is to become the General Counsel of said corporation.

All of the common stock was to be issued (R. 24)—

* * * subject to the right of the corporation for its then existing stockholders to repurchase the same in the event of such stockholder desiring to sell any portion or all of his or her shares of common stock in said corporation to any person who is now [sic—not] actively associated with such stockholder in the business of producing photoplays * * *.

The substance of this provision was included in the bylaws subsequently adopted by the corporation. (R. 24.)

On the same day the taxpayer signed a proposed distribution agreement which was subsequently executed by the corporation on June 13, 1919. Similar agreements were signed by Douglas Fairbanks, Mary Pickford and D. W. Griffith. (R. 24.) The agreement signed by the taxpayer provided, *inter alia,* that he would produce and deliver to the corporation nine photoplays of between 1,600 and 3,000 feet in length within three years from the date thereof. For its part the corporation obligated itself to give the taxpayer's name "chief prominence" in the advertise-

ments of his pictures, to use its best efforts to market the films upon a basis of sharing in gross receipts, and agreed that no franchise or territorial right for the use of such photoplays should be made without his written consent. (R. 24–25.) The contract further provided (R. 25):

> And in addition to the above consideration, one thousand (1,000) shares of the common stock of the said corporation to be delivered in escrow to a person or corporation to be agreed upon by the parties hereto and to be held by said person until said artist delivers to said corporation, nine (9) photoplays. Should said artist be unable to deliver nine (9) such photoplays because of illness or incapacity during the said entire period of three (3) years, said artist shall receive so many of the aforesaid one thousand (1,000) shares of the common stock of this corporation as the number of photoplays delivered by said artist to this corporation pursuant to this agreement bears to the number of nine. The balance of the shares of such common stock shall be delivered by such escrow agent to this corporation.

This provision was amended by an agreement entered into between the four artists and the corporation on July 5, 1919, to provide (R. 27–28):

> And in addition to the above consideration, one thousand (1,000) shares of the common stock of the said corporation to be issued in the name of the said Artist in the form of nine (9) certificates, eight (8) of which shall be for one hundred and eleven (111) shares each and

> one of which shall be for one hundred and twelve (112) shares, said certificates to be delivered in escrow to a person or corporation to be agreed upon by the parties hereto. Upon delivery by the said Artist to the said corporation of each one (1) of the first eight photoplays called for by this contract, such escrow agent shall deliver to the said Artist one (1) of said certificates for one hundred and eleven (111) shares, and upon delivery by the said Artist to the said corporation of the ninth (9th) photoplay called for hereunder, such escrow agent shall deliver to the said Artist said certificate for one hundred and twelve (112) shares. Upon the expiration of the three-year period herein provided for, so many of said certificates as are then still held by such escrow agent in accordance with the provisions of this paragraph shall be delivered by such escrow agent to the said corporation.

On April 17, 1919, the certificate of incorporation of United Artists Corporation was filed with the Secretary of State of Delaware. It authorized the issuance of 5,000 shares of preferred stock, $100 par value, and 9,000 shares of common stock. The preferred stock was to have no voting rights. Each holder of shares of common stock was entitled to as many votes at all elections of directors as his number of shares multiplied by the number of directors to be elected. (R. 24.)

On May 29, 1919, the board of directors of United Artists adopted the following resolution (R. 25–27):

> Whereas in the judgment of the Board of Directors the photoplays agreed to be delivered

to this Corporation under said contracts are necessary for the business of this Corporation and constitute good and sufficient consideration for the issue of five thousand (5000) shares of the common stock of this corporation, the same being without par or nominal value:

Resolved that, in consideration of the delivery of said contracts to this Corporation the proper officers of this Corporation be, and they hereby are, authorized to issue and deliver to William G. McAdoo, Esq.,[1] one thousand (1,000) shares of no par value of this corporation fully paid and non-assessable, said shares to include the shares of no par value subscribed for by the signers of the certificate of incorporation of this Corporation, assignments of said subscriptions being held by him; and

Resolved that, in consideration of the delivery of said contracts of this Corporation, the proper officers of this Corporation be, and they hereby are authorized to issue to said Charles Chaplin, Douglas Fairbanks, David W. Griffith and Gladys Mary Moore (professionally known as Mary Pickford) one thousand (1,000) shares of no par value each, making a total of four thousand (4,000) shares of no par value to a person or corporation to be agreed upon by said Charles Chaplain, Douglas Fairbanks, David W. Griffith and Gladys Mary Moore (professionally known as Mary Pickford) and this Corporation, and to no other person, said four

[1] These shares were surrendered to the corporation by McAdoo in 1920, and subsequently in 1924, 1,000 shares were issued to Joseph M. Schenck. None of this stock was ever put in escrow. (R. 34.)

thousand (4,000) shares to be held by said person or corporation in escrow in accordance with the provisions of said contracts between said Charles Chaplin, Douglas Fairbanks, David W. Griffith and Gladys Mary Moore (professionally known as Mary Pickford) and this Corporation; and

Resolved that the proper officers of this Corporation be, and they hereby are, authorized and directed to execute an escrow agreement for the holding and delivery of said four thousand (4,000) shares of non-par value in accordance with the terms and provisions of said contracts between said Charles Chaplin, Douglas Fairbanks, David W. Griffith and Gladys Mary Moore (professionally known as Mary Pickford) and this Corporation dated February 5th, 1919, said escrow agreement to provide that while said four thousand (4,000) shares are held in escrow, each of the aforesaid artists shall have the right to vote his or her respective holdings thereof; provided that said escrow agreement shall be approved by the general counsel of this corporation before execution of the same by its officers.

On June 9, 1919, the corporation issued nine certificates of stock—eight for 111 shares each and one for 112 shares—in which the taxpayer was shown as the owner. The certificates were not delivered to the taxpayer, but were kept in the possession of the corporation until subsequently delivered to the escrow agent in accordance with the agreement between the taxpayer and his associates and with the corporation. (R. 27.)

The following entry appears in the journal of the corporation (R. 27):

June 9 [1919] Artists' Contracts		A–4	$25,000.00
Consideration for contracts with the four artists for delivery of photoplays to Corporation as per resolution of Board of Directors adopted May 29, 1919 (ratified by stockholders, Sept. 9, 1919)			
Capital Stock—Common		C–7	$25,000
Issued 5,000 shares at no par value, but regarded to have a value of $5.00 per share (verbal advice of General Counsel)			

On August 5, 1919, the taxpayer and the corporation entered into an agreement with one Dennis F. O'Brien. This agreement provided for the delivery by the corporation to O'Brien, as escrow agent, of nine certificates representing 1,000 shares of common stock and for the delivery by the depositary of a certificate of deposit to the taxpayer, who was referred to as the Artist. (R. 28.) The agreement went on to provide (R. 28–30):

* * * * *

> Third: Upon delivery by the Artist to the Corporation of each one (1) of the first eight (8) photoplays called for by the aforesaid contract, the Corporation shall notify the Depositary in writing that the Artist is entitled to one (1) of said certificates for one hundred and eleven (111) shares, whereupon the Depositary shall deliver one (1) of the same to the Artist upon surrender by the latter of the certificate of deposit herein provided for and shall issue to the Artist a new certificate of deposit, substantially in the form of that annexed hereto, in respect of the number of shares remaining in escrow. Upon delivery by the Artist to the Corporation

of the ninth (9th) photoplay called for by the aforesaid contract, the Corporation shall notify the Depositary in writing that the Artist is entitled to said certificate for one hundred and twelve (112) shares, whereupon the Depositary shall deliver the same to the Artist upon surrender by the latter of the certificate of deposit which he then holds. At the expiration of said period of three years, the Depositary shall deliver to the Corporation so many of the certificates deposited hereunder as then remain in escrow and are not the property of the Artist, and the Artist shall return to the Depositary the certificate of deposit which he then holds.

Fourth: Any and all dividends which may be declared upon the shares of stock represented by the certificates deposited hereunder while the same, or any part thereof, are held in escrow by the Depositary shall be deposited by the Corporation in the Central Union Trust Company, No. 80 Broadway, New York City, in an account to be known as "United Artists Corporation, Trust Account No. 1." Upon delivery to the Artist by the Depositary, in the manner hereinbefore provided for, of each of the certificates deposited hereunder, the Corporation shall pay to the Artist one-ninth (1/9) of all dividends which at the time of such delivery shall have been deposited in said account, together with accrued interest thereon. At the expiration of said period of three years, so much of such dividends and interest thereon as remain in said account and are not due the Artist shall become the property of the Corporation.

> Fifth: The Depositary shall not have the right to vote the shares of stock deposited hereunder.
>
> * * * * *

The certificate of deposit recited that O'Brien held the stock for the benefit of the taxpayer (who was referred to therein as the "Beneficiary") and that delivery of the stock or portions thereof would be made to the taxpayer upon the receipt by the depositary of written notice from the corporation that the taxpayer was entitled thereto under the terms of his agreement with corporation. The certificate of deposit also stated that the holder thereof "shall have the same voting rights as a holder of a regular certificate of common stock of United Artists Corporation." (R. 30.)

The taxpayer did not deliver any motion pictures to the corporation during the three-year period referred to in the contracts, nor had any of the parties delivered all of the nine pictures referred to in their contracts with the corporation. Although the agreements were not modified to extend the three-year period for the delivery of the pictures, all of the parties continued to treat the agreements as in full force and effect, and none of the stock held in escrow was redelivered to the corporation. In 1923 the taxpayer delivered to the corporation one motion picture and received from the escrow agent one certificate for 111 shares of stock. This left eight pictures undelivered and eight certificates of stock still held by the escrow agent. (R. 30–31.)

On November 22, 1924, the taxpayer, Mary Pickford, Douglas Fairbanks, Joseph Schenck and the corporation entered into an agreement further modifying the distribution agreement of February 5, 1919. It recited that "Miss Pickford, Chaplin, Fairbanks and Griffith are the owners of all of the preferred and common stock of the corporation, now issued and outstanding" except certain qualifying shares. It provided that Miss Pickford and Fairbanks would produce by November 1, 1928, designated numbers of pictures in addition to the nine each had originally promised, but neither of them was to receive any additional common stock. (R. 31–32.) It further provided for the reduction of the taxpayer's remaining quota of eight pictures to five, to be delivered, one each year, by January 1, 1929, and stated (R. 32):

> The balance of the common stock of the corporation, which is now held in escrow for the benefit of Chaplin shall be delivered to him in the proportion of one fifth (⅕) thereof upon the delivery of each motion picture photoplay by Chaplin to the corporation.

The taxpayer delivered to the corporation one picture in 1925 and another in 1928. In the latter year new certificates were issued by the corporation in place of the old ones, the taxpayer receiving three certificates for a total of 499 shares and O'Brien, the escrow agent, receiving three certificates for a total of 501 shares. In 1931 the taxpayer delivered another picture and received from the depositary a certificate for 167 shares. All of the pictures delivered by the

taxpayer to the corporation were much longer than the 1,600 to 3,000 feet specified in the agreement. (R. 32, 33.)

On September 20, 1935, an agreement was entered into between the taxpayer and the corporation under which the remaining two certificates (Nos. 87 and 88, each for 167 shares) were released to the taxpayer, together with accumulated dividends thereon in the sum of $44,532.22, which had been paid to the escrow agent during the years 1930 to 1934. The dividends had been deposited in a special bank account and interest on the deposits in the amount of $995 was paid to the taxpayer when the stock and dividends were released. This amount was included in gross income in the taxpayer's income tax return for 1935. (R. 33–34.)

When the original nine certificates totaling 1,000 shares of stock were put in escrow, the taxpayer did not sign them. When these certificates were canceled by the corporation and six certificates totaling 1,000 shares were issued in their stead, and placed in escrow, the taxpayer signed these six certificates in blank. (R. 34.)

After the organization of the corporation, the taxpayer attended stockholders' meetings, voted at such meetings for directors and otherwise, received notices and signed proxies the same as any stockholder. He was carried on the books of the corporation as the owner of 1,000 shares of common stock. The dividends upon the stock standing in his name were deposited in a trust account in a New York bank in accordance with the escrow agreement. (R. 34.)

The taxpayer did not include the value of the 334 shares of United Artists stock in his income tax return for 1935. The item of $44,532.22 which the taxpayer received on September 20, 1935, together with the stock certificates, was reported but was treated by the taxpayer as a dividend, and therefore not subject to the normal tax. The Commissioner determined that the 334 shares of stock constituted income in the year 1935, in the amount of $104,709 which he determined to be the fair market value. The Commissioner also determined that the item of $44,532.22 did not represent "dividends" received in the taxable year, but was to be treated as ordinary income, and therefore subject to the normal tax. (R. 10–13, 34–35.) The Board of Tax Appeals held (1) that the United Artists' stock constituted income in 1935, and (2) that the item of $44,532.22 was "received as dividends from a domestic corporation" within the meaning of Section 25 (a) (1) of the Revenue Act of 1934, and therefore not subject to normal tax. One member dissented from the holding upon the first point and one member dissented from the holding upon the second point. (R. 35–45.) The taxpayer seeks review upon the Board's decision on the first point, and the Commissioner seeks review of the Board's decision upon the second point.

STATEMENT OF POINTS TO BE URGED BY COMMISSIONER

The Commissioner's assignments of error, all of which are here relied upon, appear in the Record at pages 335–337. They may be summarized by the

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simple statement that the Board erred in holding that the item of $44,532.22 was not subject to normal tax.

SUMMARY OF ARGUMENT

I

The Board correctly decided that the 334 shares of United Artists stock constituted income to the taxpayer in 1935. The taxpayer's contention that he became the owner of the stock in 1919 is in the teeth of the unequivocal terms of the contracts under which his rights were derived. The clear terms of all of the agreements among the parties permit of no conclusion other than that the taxpayer was to receive the stock only in consideration of the delivery by him to the corporation of the promised photoplays. He was *not* to get the stock *unless and until* he delivered the pictures. The elaborate escrow agreement was devised for this very purpose and loses most of its significance if it be construed otherwise than in accordance with its plain language.

Insofar as the taxpayer's contention rests upon the evidence outside of the contracts, it constitutes essentially an attempt to have this Court determine where the preponderance of the evidence lies. The testimony of the witnesses and the various exhibits were, at best, but evidentiary in value. What inferences were to be drawn from that evidence and the weight to be accorded those inferences were for the Board to determine. The scope of the review extends only to a determination of whether the record compels a conclusion contrary to that reached below. Moreover

there is really no inconsistency between the contracts and the evidence relied upon by the taxpayer.

It is unnecessary to determine in this proceeding whether the stock was issued at all by the corporation prior to 1935; or, if it was issued, whether it had been lawfully issued. For, regardless of how those points might be decided, we think it must be held that for income tax purposes the taxpayer was required to account for the stock in 1935.

II

The item of $44,532.22 is not free from normal tax since it was not a dividend within the meaning of Section 25 (a) (1) of the Revenue Act of 1934. Despite the designation of the item as "accrued dividends", the corporation did not irrevocably part with the money at the time of declaration. The taxpayer was in exactly the same position with respect to this item as he was with respect to the stock. Although the corporation did part with the money in 1935, when it was turned over to the taxpayer, the item at that time no longer constituted a dividend. It merely represented part of the contractual compensation for the performance of the distribution agreement.

ARGUMENT

I

The Board correctly decided that the 334 shares of United Artists stock constituted income to the taxpayer in 1935

Introduction: The issue upon this branch of the case arises out of the Commissioner's determination,

and the Board's affirmance thereof, that the taxpayer was required to account in the year 1935 for the 334 shares of United Artists stock represented by the certificates numbered 87 and 88.

The Board of Tax Appeals resolved the issue by determining that the taxpayer was not the owner of the shares prior to their delivery to him in 1935. The taxpayer contends that he became the owner of the stock in 1919.[2] Insofar as this contention turns upon the terms of the various agreements under which the stock was issued, we submit, and shall show, *infra*, that the contention is patently erroneous. Insofar as the taxpayer's argument is based on the contention that evidence *aliunde* the contracts establishes that it was the intention of the parties that the taxpayer was to acquire complete ownership of the stock in 1919, the argument consists essentially of an attempt to have this Court reweigh the evidence which was considered by the Board. The Board has found, upon a consideration of all the evidence, that (R. 38):

> * * * it was the intention of the parties that ownership of the stock should not pass to petitioner until and unless he "fulfilled" the terms and conditions of his contract and de-

[2] It seems to be agreed that for purposes of the federal revenue law the value of the stock became taxable income when the taxpayer first received the substantial incidents of ownership. Such incidents of ownership necessarily depend upon local law, but they do not depend upon the labels or terms which local law may apply. Thus, even assuming, solely for the sake of argument, that under local law the taxpayer were momentarily vested with "legal title" in 1919 or at all times since 1919 were regarded as the holder of "legal title", this would not be determinative. See, e. g., *Morgan* v. *Commissioner*, 309 U. S. 78, 80–81.

livered to the corporation the photoplays stipulated therein.

We think it important to make this point at the outset, for the taxpayer's argument is keyed to a fundamentally erroneous approach; it misconceives the nature of the question before this Court. Of course the Board's decision in the instant case is subject to review here, but it must be constantly borne in mind that the scope of the review does not extend to a retrial of the case. The basic question presented to the Board was the determination of whether the taxpayer had substained the burden of proving that he was not required to account for the United Artists stock in the year 1935. In resolving this question the Board considered the language of the contracts and the sum of all of the other evidence in the case, both documentary and oral. To reach a conclusion, the Board was required to place in the balances the various items of proof, to assign to them relative values, to draw inferences from them and to assay the value of those inferences, both qualitatively and quantitatively. But that function having been exercised by the Board, that phase of the controversy is no longer open; the scope of the review does not extend to a re-evaluation of the evidence. Therefore, the question before this Court is fundamentally different from that which faced the Board of Tax Appeals. The issue here is whether the evidence *requires* a conclusion contrary to that which was reached below. *Wilmington Trust Co.* v. *Commissioner,* 316 U. S. 164; *Helvering* v. *Kehoe,* 309 U. S. 277; *Bank of California* v. *Commissioner* (C. C. A.

9th), decided January 29, 1943, not yet officially reported.

Of course the Board's decision may be reversed if there is a lack of substantial evidence to support it. But it may not be reversed upon a consideration of the preponderance of the evidence, or even if it is concluded that there is substantial evidence in support of the taxpayer's view of the case. The issue here is whether the evidence *compels* a conclusion contrary to that reached by the Board.

Despite this well-settled rule the taxpayer's brief approaches the question as though this Court were free to determine where the preponderance of the evidence lies. Thus, reliance is placed upon a series of exhibits (Br. 29), which, it is contended, indicate that the corporation treated the taxpayer as the owner of the stock prior to 1935. Stress is placed on the testimony of O'Brien (Br. 20, 35–36, 42–44) and on that of the taxpayer (Br. 34–35), as though such testimony were conclusive. But it is fundamental that the Board is not obliged to give such treatment to testimony (*Helvering* v. *Nat. Grocery Co.*, 304 U. S. 282, 295; *Bank of California* v *Commissioner, supra*), especially where, as here, the testimony conflicts with written contracts under which the rights of the parties are derived. Moreover, the taxpayer's recollection was exceedingly vague (R. 321) and O'Brien testified mainly in terms of the ultimate conclusion which the Board itself had to reach. (See the excerpt in the taxpayer's brief, pp. 42–44.) The various exhibits consisting of proxies, minutes of stockholders' meetings, journal entries in the corporation's

books, stock certificates, and the like, were, of course, evidentiary in value, but in no sense could they be deemed to have conclusive effect upon the fundamental issue in the case. We submit that upon the record made in the instant case it cannot be said that a conclusion contrary to that reached below is compelled. Indeed, although it is unnecessary that we go that far, we submit that the record could hardly support a contrary conclusion.

1. The agreements pursuant to which United Artists was formed and under which the taxpayer undertook to deliver to the corporation motion pictures for marketing and distribution are so clear as to permit of no doubt as to their meaning. The very first agreement, that of February 5, 1919, which provided for the formation of the corporation, provided that the rights of the parties to the common stock of the corporation were to depend upon the agreements relating to the marketing and distribution of the motion pictures which it was contemplated they would produce. The first of these distribution agreements entered into by the taxpayer was executed on the same day on which the parties contracted for the formation of the corporation. It states unambiguously that the common stock was to be held in escrow, and was not to be delivered to the taxpayer except as he delivered to the corporation the promised photoplays. It is significant that the agreement anticipated the contingency that illness or incapacity might have prevented the taxpayer from delivering the required number of photoplays, it being specifically provided that, in that event, the taxpayer was to receive only a proportion-

ate number of shares of the common stock held in escrow, and the balance of the stock was to be delivered by the depositary to the corporation. The amendment of this provision, made by the agreement of July 5, 1919, provides even more precisely that the taxpayer was to get the stock only upon delivery of the promised motion pictures. The 1,000 shares of stock were to be divided into nine certificates, all to be held in escrow. One certificate was to be released to the taxpayer for each photoplay delivered to the corporation, and at the end of the three-year period the balance of the certificates still held by the depositary were to be delivered to the corporation. The resolution of May 29, 1919, authorizing the issuance of the 1,000 shares of stock also carefully provided that the stock was to be held in escrow, and was to be delivered to the artists only in accordance with the provisions of their distribution contracts with the corporation. The escrow agreement of August 5, 1919, also states in clear language that the stock was to be delivered to the taxpayer only as he delivered the promised pictures. It is especially to be noted that this contract states (R. 29):

> At the expiration of said period of three years the Depositary shall deliver to the Corporation so many of the certificates deposited hereunder as then remain in escrow *and are not the property of the Artist,* and the Artist shall return to the depositary the certificate of deposit which he then holds. [Italics supplied.]

This is a clear recognition that the stock was not to become the property of the artist until delivered to

him by the depositary. In addition, the expenses of the depositary were paid by the corporation, not by the taxpayer. (R. 147, 234.)

The escrow agreement of August 5, 1919, also makes it plain that the taxpayer was not to be entitled to any dividends upon any stock not released from escrow. Article Fourth provides specifically that any dividends declared upon the stock held in escrow were to be held under the same terms as those which related to the holding of the stock. The taxpayer was to receive those "accrued dividends" upon each of the certificates as he received the certificates, but he was to receive neither those "accrued dividends" nor the certificates unless he performed his distribution contract.

When the arrangement among the parties was modified on November 22, 1924, the agreement then entered into also carefully provided that the common stock then held in escrow for future delivery to the taxpayer was only to be delivered to him as he delivered the promised motion pictures to the corporation.

Thus, throughout all of the negotiations and throughout all the agreements among the parties there was a sharp distinction between the preferred stock of the corporation and the common stock. The preferred stock was to be subscribed to at the outset for cash and was to be redeemed as soon as practicable. The obvious purpose of this arrangement was to finance the corporation during its initial years. Thereafter all of the interests in the corporation were to be

represented by the common stock. Great care was taken, however, to make certain that each of the artists would make equal contributions to the corporation in the motion pictures which were essential to the success of the enterprise. None of the parties was to benefit beyond the extent to which he contributed to that success. Indeed, even the agreement of November 22, 1924, under which the taxpayer's remaining quota of pictures was reduced from eight to five, was based upon the same underlying thought. The measure of the taxpayer's obligation was fixed so as to require him to deliver pictures which grossed an amount equal to that represented by the pictures delivered by the other artists. (R. 215.)

The taxpayer contends (Br. 20–21, 41–48) that under these agreements he became the complete owner of the stock in 1919, when the first agreements were executed, and suggests that, pursuant to an "independent contract", the stock and the dividends thereon were held as security for performance by him of the distribution agreement. The plain fact of the matter is, however, that there was no independent contract, and that it was of the very essence of the entire arrangement that the taxpayer was not to become the owner of the stock until he delivered the promised photoplays. All of the documents relating to the issuance of the common stock were carefully drawn so as to provide that the taxpayer was *not* to receive the stock *unless and until* he delivered the pictures.

We think it is significant that the stock was placed in escrow under an elaborate arrangement, precisely detailed. The term "escrow" is a word of art, having

a definite meaning. It is fundamental that the rights of a transferee under a deposit in escrow do not vest until the depositary makes a proper delivery of the property to him. The transfer is not complete until performance of the condition upon which it is to take effect. That is the essential meaning of the term, and is the meaning which obtains both in New York and in California.[3] The point was stated succinctly by Chief Justice Kent in *Jackson* v. *Catlin,* 2 Johns 248, 259 (N. Y.) in the following language:

> A deed is delivered as an *escrow* when the delivery is conditional, that is, when it is delivered to a third person, to keep until something be done by the grantee; and it is of no force until the condition be fulfilled.

See also *Fargo* v. *Burke,* 262 N. Y. 229, 186 N. E. 683.

Section 1057 of the Civil Code of California provides:

> A grant may be deposited by the grantor with a third person, to be delivered on performance of a condition, and on delivery by the depositary, it will take effect. While in the possession of the third person, and subject to condition, it is called an escrow.

See also *In re Reed,* 204 Cal. 119, 266 Pac. 948.

[3] The contract of February 5, 1919 (R. 114–139), provides (R. 137) that it shall be construed and enforced according to the law of New York. It appears (R. 137–139) to have been executed by the taxpayer in California, and by United Artists in New York. The amendment thereto of July 5, 1919 (R. 140–141), and the escrow agreement of August 5, 1919 (R. 143–147) contain no such provision and it is not shown where they were executed. The contract of November 22, 1924 (R. 149–165), recites that it was executed in New York.

Moreover, it is to be noted that in the instant case it was expressly provided that the stock should never be delivered to the taxpayer to the extent that he failed to perform.

We submit that it is a patent distortion of the very essence of the agreements to construe them as though they had provided for the immediate delivery of the stock to the taxpayer, and a pledge of that stock by the taxpayer to secure his performance of his contractual obligations. The taxpayer never had sufficient dominion over the stock in order to pledge it as security. Until performance by him of his contract and delivery to him by the depositary of the stock, there was never a moment of time when he had any freedom of action concerning it.

Furthermore, the elaborate escrow agreement loses most of its significance if it is viewed as a mere security device. If that were the true meaning of the arrangement the taxpayer would have been in a position to relieve the stock of the burden of the pledge by paying damages for any breach of performance. This would certainly not have satisfied the repeatedly expressed intention of the parties, for the success of the enterprise depended entirely upon the availability to the corporation of photoplays produced by the then leading people of the industry. And it is to be further noted that the arrangement was needlessly complex as a security device. A simple pledge, or, since the stock was restricted against alienation (R. 90, 107, 111–112), even a simple contractual provision would have sufficed for that purpose. Indeed, the taxpayer appears to have conceded this point. (Br.

48.) The escrow arrangement does have significance, however, and indeed was necessary, if the words of the agreements are read according to their plain meaning—the taxpayer was not to get the stock except as compensation for the performance of his contract. In the light of the clear words of these agreements we submit that there can be no adequate basis for a reversal of the Board's decision upon this branch of the case. *Southern Power & Mfg. Co.* v. *Commissioner,* 82 F. 2d 104 (C. C. A. 5th).

2. It is contended by the taxpayer and reiterated throughout his brief, that he enjoyed and exercised all of the incidents of ownership of the stock while it was in escrow. We submit that there is no basis for that contention and, that, on the contrary, it is clear that the taxpayer did not enjoy the fruits of ownership of the stock during that period. The only right normally associated with the ownership of stock which the taxpayer had during that time, was the right to vote. Although the right to vote is one of the usual incidents flowing from the ownership of stock, the existence of that right is certainly not a sufficient basis upon which to predicate a conclusion of ownership. As the Board pointed out (R. 39), the right to vote may be conferred by contract upon, and is frequently exercised by, persons having no beneficial ownership of stock in the corporation. *Alger-Sullivan Lumber Co.* v. *Commissioner,* 57 F. 2d 3 (C. C. A. 5th). The stockholders of a corporation may agree among themselves that a person who is not a stockholder shall have a voice in the management of the corporation, and since in the instant

case the corporation was a close one formed to carry out a purpose in which all of the parties were greatly interested, the arrangement is not surprising. There is, therefore, no necessary inconsistency between a conclusion that the taxpayer did not become the owner of the stock until it was released from escrow and the fact that he was entitled by contract to participate in the management of the corporation prior to that time.

In any event it is clear that under the express terms of the contract the taxpayer was denied the most fundamental of the fruits of ownership of stock, namely, the right to receive dividends thereon. For dividends declared upon the stock while it was in escrow were, like the stock itself, to be delivered to the taxpayer only upon performance by him of his obligations under the distribution agreement, and in the event of nonperformance, were to be returned to the corporation. Indeed, as we shall attempt to show under point II, *infra,* the amounts denominated "dividends" were not true dividends but really represented additional contractual compensation. We do not believe it to be of any significance that the compensation under the contract also included interest upon these amounts, especially since the interest was paid by the bank in which they were deposited and not by the corporation. (R. 306–307.)

The taxpayer also contends that he was considered to be the owner of the stock by the corporation at all times after 1919. The argument is based upon a series of exhibits consisting of minutes of the corporation,

proxies, journal entries on the corporation's books, and the like, which refer to the taxpayer as the owner. But of course the label which the parties placed upon the relationship is not conclusive of the nature of that relationship,[4] nor are the book entries of the corporation more than evidentiary in value.[5] Since, under the agreement among the organizers of the corporation, the taxpayer was permitted to vote while the stock was in escrow, it was not unnatural to describe him in notices of meetings, in proxies and in the minutes of the corporation as a stockholder. However, no issue ever arose between the taxpayer and the corporation in which it became necessary to determine whether or not he really owned the stock. The issue might have arisen if, for example, the taxpayer had died while the stock was in escrow. The stock could not have passed as part of his estate for the condition upon which it was being held had not been fulfilled. And since the distribution contract was personal, especially insofar as the taxpayer's performance was concerned (R. 130, 131), the condition could never be performed, and the personal representative could therefore never acquire the stock. In any event the

[4] "The label counts for little." *Stearns Co.* v. *United States*, 291 U. S. 54, 61. See also *Helvering* v. *Richmond, F. & P. R. Co.*, 90 F. 2d 971 (C. C. A. 4th); *Bakers' Mutual Coop. Assn.* v. *Commissioner*, 117 F. 2d 27 (C. C. A. 3d); *Leland* v. *Commissioner*, 50 F. 2d 523 (C. C. A. 1st); *Johnson Locke Mercantile Co.* v. *Burnet*, 51 F. 2d 434 (App. D. C.)

[5] *Helvering* v *Midland Ins. Co.*, 300 U. S. 216, 223; *Doyle* v. *Mitchell Brothers Co.*, 247 U. S. 179, 187. "The bookkeeping creates nothing." *Sitterding* v. *Commissioner*, 80 F. 2d 939, 941 (C. C. A. 4th).

various exhibits were but evidence. They certainly were not conclusive, especially in view of the clear terms of the contracts.

It is also suggested (Br. 49 *et seq.*) that the terms of the distribution agreement were abandoned both by the corporation and by the taxpayer. The short answer to this contention is that it is not shown how, if there were such an abandonment, it operated in any way to ripen the taxpayer's interest in the stock. Moreover, the contract specifically provides (R. 129):

> The parties hereto agree that any waiver by said artist or the corporation of any breach of any kind or character whatsoever by the other, whether such waiver be direct or implied, shall not be construed as a continuing waiver of, or consent to, any subsequent breach of this contract on the part of the other, and particularly as regards the making and delivery of the statements and of the keeping of the accounts, and of the delivery of the photoplays herein provided.
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> * * * * *

3. It is contended by the taxpayer that he acquired the stock in 1919 in consideration of the execution by him of the distribution agreement, and that the ripening of his right to the stock did not depend upon performance of that agreement.[6] In this connection it is argued that under Section 3 of the Delaware Cor-

[6] Under the taxpayer's theory all of the stock would have constituted taxable income to him in 1919. But the taxpayer introduced no evidence to show that he had accounted for the stock in his return for that year, nor does it otherwise appear from the record that he did so.

poration Law the corporation could not have issued the stock except for property received; that the corporation could not have issued the stock to itself and unless someone other than the corporation owned it, no dividends could have been declared upon it; that the depositary did not own it; and that it therefore follows that ownership of the stock was vested in the taxpayer. It is to be noted that the fundamental premises upon which all of these propositions are based are: (1) That the stock was actually issued by the corporation while it was held by the depositary, and (2) that if it was issued, the action of the corporation in so doing was proper. We do not believe it would be helpful to enter into an extended discussion upon these points. Should the issue have arisen in some other connection it might very well have been held that the correct analysis of the entire transaction is that the stock here involved was not really issued in any sense prior to 1935. It is true that certificates were prepared by the corporation, but the mere preparation of certificates does operate to constitute the person named therein as the owner of any stock. If it should be assumed that for some purposes the stock would be considered as having been issued prior to 1935, it by no means follows that it was lawfully issued within the meaning of Section 3 of the Delaware Corporation Law. Certainly the action of the corporation in declaring so-called "dividends" upon this stock would not prove either (a) that the stock was issued at all, or (b) that, if it was issued, it had been done so lawfully. The important point is that

in the instant case it is unnecessary to decide any of these questions. It is completely immaterial whether for the purpose of satisfying Section 3 of the Delaware Corporation Law it might be held that the consideration for the issuance of the stock was the execution of the distribution agreement.

Regardless of how those points might be decided we think it clear that the taxpayer was required to account for the stock for income tax purposes in 1935. *Olson* v. *Commissioner,* 24 B. T. A. 702, affirmed, 67 F. 2d 726 (C. C. A. 7th), certiorari denied, 292 U. S. 637; *Stiver* v. *Commissioner,* 90 F. 2d 505 (C. C. A. 8th); *Big Lake Oil Co.* v. *Commissioner,* 95 F. 2d 573 (C. C. A. 3d), certiorari denied, 307 U. S. 638; *Silberblatt* v. *Commissioner,* 28 B. T. A. 73. In the *Olson* case, *supra,* a corporation agreed to compensate its officers with stock in the corporation in consideration of their remaining in the employ of the company. The stock was issued annually to a trustee for five years and at the end of that period was turned over to the officers by the trustee, but the officers were entitled to and did receive all dividends on all of the stock in the interim. It was held that all of the stock was income in the last year when it was received from the trustee.

In the *Silberblatt* case, *supra,* the taxpayer entered into a contract in 1925 for the sale of stock at a price less than its cost. Part of the purchase price was paid in 1925 but the balance was not due until 1926. The stock was placed in escrow to be delivered to the purchasers upon payment of the balance, and to be

returned to the vendor upon default in payment. The payment was completed and the stock was delivered to the purchasers in 1926. It was held that the loss was not deductible in 1925, but was properly to be reflected in the return for 1926. The *Stiver* case, *supra,* presented a similar question and was similarly decided.

Big Lake Oil Co. v. *Commissioner, supra,* involved facts very much like those in the case at bar. There the taxpayer was engaged in producing oil and entered into an agreement with others to organize a pipe line company. As in the instant case, the working capital was to be furnished by means of preferred stock which was later to be retired. Under the agreement the taxpayer was entitled to common stock in the new corporation, but it was placed in escrow until the retirement of the preferred stock. It was held that the income represented by the stock was realized in the year in which the escrow was terminated.

In the instant case the taxpayer transferred nothing to the corporation in 1919 for the common stock and did not receive it then. He merely entered into a contract with the corporation under which he might receive it in the future. When the escrow was terminated he had for the first time unqualified and unconditional rights in the stock. Until that time he could not properly be said to have realized any income. *Cf. Lucas* v. *American Code Co.,* 280 U. S. 445; *Lucas* v. *North Texas Co.,* 281 U. S. 11; *North American Oil* v. *Burnet,* 286 U. S. 417; *United States* v. *Safety Car Heating Co.,* 297 U. S. 88.

The cases cited by the taxpayer do not support a contrary conclusion. Furthermore, even a squarely contrary Board decision would not constitute an authority for a reversal of its decision in the instant case (*Rogers* v. *Commissioner,* 103 F. 2d 790, 793 (C. C. A. 9th); *Hirsch* v. *Commissioner,* 124 F. 2d 24, 30 (C. C. A. 9th)), and we believe that the same thing may be said of the District Court decision in *Schneider* v. *Duffy,* 43 F. 2d 642 (N. J.). We point out, however, that there are vital distinctions between the cases relied upon by the taxpayer and the instant case. *Schneider* v. *Duffy, supra,* involved a contract under which a corporation promised to pay 1,500 shares of stock to one of its officers as part of his compensation. Although the certificates were delivered to him over a five-year period, the contract expressly provided that he was to receive all dividends on the entire 1,500 shares from the time of execution of the contract. As we have pointed out, in the instant case the taxpayer had no right to dividends on any stock held in escrow unless and until he performed his contract and became entitled to receive the stock. In addition it is to be noted that in *Schneider* v. *Commissioner,* 3 B. T. A. 920, the Board of Tax Appeals reached, upon the same facts, a result squarely contrary to that reached by the District Court in the *Schneider* case. The Board's conclusion was sustained in *Glenn* v. *Bowers* (S. D. N. Y.), affirmed, *Glenn* v. *Bowers,* 65 F. 2d 1017 (C. C. A. 2d), certiorari denied, 290 U. S. 681. See 1943 C. C. H., par. 53,111. See also *Olson* v. *Commissioner,* infra.

In *Hopkins* v. *Commissioner,* 41 B. T. A 1292, there was involved a contract for the sale of stock under which it was agreed that the stock was to be held by a bank until the purchase price was paid. It was provided, however, that all dividends declared upon the stock while it was held by the bank were to belong to the purchaser. The same thing is true of *Carnahan* v. *Commissioner,* 21 B. T. A. 93. *Ambassador Petroleum Co.* v. *Commissioner,* 28 B. T. A. 873, merely holds that delay by a corporation in preparing certificates does not necessarily mean that the stock had not been issued prior to preparation of the certificates. The case represents no more than an application of the general rule that certificates are but evidences of stock ownership.

We submit that this branch of the case has been correctly decided by the Board.

II

The item of $44,532.22 is not free from normal tax since it was not a dividend within the meaning of Section 25 (a) (1) of the Revenue Act of 1934

In addition to the 334 shares of United Artists stock which the taxpayer received in 1935 from the depositary, he also received the amount of $44,532.22 which represented "accumulated dividends" which had been paid to the depositary by the corporation in the years 1930 to 1934.[7] These amounts had been kept by the depositary in a special bank account. For the reasons which have been developed under

[7] Interest on the deposit in the amount of $995 was also paid to the taxpayer. No dispute arises concerning this item.

point I in this brief we think it clear that these "accumulated dividends" constituted income to the taxpayer in the year 1935. The further question, which is presented by the Commissioner's appeal, is whether this item constituted a dividend within the meaning of Section 25 (a) (1) of the Revenue Act of 1934, *supra*. That section grants a credit in the computation of the normal tax for amounts "received as dividends from a domestic corporation". The Board of Tax Appeals (one member dissenting) has held that the taxpayer is entitled to this credit. We submit that that holding is erroneous.

Under the terms of the contracts, which have already been discussed at length, and under the findings of the Board, the taxpayer was not entitled to the stock until he had performed his obligations under the distribution agreement. He was in exactly the same position with respect to the so-called "accrued dividends". At the time of declaration the corporation did not irrevocably part with any money. Moreover, the items could not have been dividends at the time of declaration, since by hypothesis the taxpayer was not a shareholder (insofar as the stock here involved is concerned) at that time, and Section 115 (a) defines a dividend as a "distribution made by a corporation to its shareholders". Although the corporation did part with the money in 1935, when it was turned over to the taxpayer, the item at that time no longer constituted a dividend. Under the terms of the agreements such items merely represented part of the contractual compensation for the photoplays produced by the taxpayer. A payment of money by a corpora-

tion under such circumstances does not constitute a dividend. *Weaver* v. *Commissioner,* 58 F. 2d 755 (C. C. A. 9th).

Similar questions were raised in *Curran* v. *Commissioner,* 49 F. 2d 129 (C. C. A. 8th) and *Thorp* v. *Commissioner,* 32 B. T. A. 767. See also *Mattis* v. *Becker* (E. D. Mo.), decided June 9, 1937 (19 A. F. T. R. 1331). *Cf. Mid-West Rubber Reclaim Co.* v. *Commissioner,* 131 F. 2d 156 (C. C. A. 7th). In the *Curran* case the issue raised was whether a payment by a corporation to its stockholders, which was denominated a dividend, was a true dividend or was really a payment for property purchased. The court said (p. 131):

> When this statute seeks to tax income as derived from corporate dividends, obviously, it means income derived from corporate earnings which accrue to the stockholder *solely because of his relation as such to the corporation.* It has no design to so tax money paid to the taxpayer as the purchase price of property. The form is not conclusive evidence that the payment really and essentially and solely was a corporate dividend.
>
> * * * * *
>
> The payment was, except in bare form, no dividend, but it was really a payment for property purchased * * *. [Italics supplied.]

The *Thorp* case, *supra,* raised the exact question presented by the instant case. There the taxpayers, who were attorneys, entered into a contract to conduct litigation to obtain the recovery of certain shares of stock, their compensation to be ten percent of the

amount recovered. Pending the outcome of the litigation the stock was placed in escrow in the year 1926. In 1928 the litigation terminated and the attorneys received their portion of the stock, together with a portion of the dividends which had been declared thereon in the interim. With respect to the latter item the Board held that it was not free from normal tax, stating (p. 768):

> When petitioners received it in 1928 it had lost its character as a corporate distribution and they received it only by virtue of their contract for services. To them it was compensation for services, and the Commissioner correctly treated it as such.

We submit that in the instant case the payments, however they might have been characterized when they were made to the depositary, were not dividends within the meaning of Section 25 (a) (1) when they were received by the taxpayer in 1935.

CONCLUSION

The decision of the Board of Tax Appeals should be affirmed on the taxpayer's appeal and reversed on the Commissioner's appeal.

Respectfully submitted,

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FEBRUARY 1943.

U. S. GOVERNMENT PRINTING OFFICE: 1943